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No. 87-1963

In the Supreme Court of the United States

OCTOBER TERM, 1988

ANIELA KOZIARA, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

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Petitioners contend that royalty payments received by them pursuant to a unitization order entered without their consent constitute proceeds of an involuntary conversion of their property under Section 1231 of the Internal Revenue Code,[1] and therefore are taxable as capital gains, rather than ordinary income.

1. Petitioners Aniela Koziara and her son, Eugene, jointly owned three tracts of land overlying a portion of a large reservoir of oil and gas in St. Clair County, Michigan known as the Columbus 3 Pool.[2] Two of these tracts

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code).

[2] Laura Koziara is a party solely by virtue of having filed joint income tax returns with her husband, Eugene Koziara. For convenience, we will use the term "petitioners" to refer to Aniela Koziara and Eugene Koziara, who are the parties who received the royalty payments.

contained producing wells and were held subject to leases that conveyed to others the right to develop and produce oil and gas, but reserved to petitioners royalty interests in the oil and gas produced. Pet. App. B3-B4, E2-E4.

In 1974, the Michigan Supervisor of Wells approved a unitization plan for the Columbus 3 Pool that had been proposed by Sun Oil Company, which already held the working interest on the largest of petitioners' tracts. Unitization permits an entire field to be operated as a single unit without regard to surface boundary lines and is designed to increase the total recovery of oil and gas from the field. When a field is unitized, the owners of tracts within the field receive royalties on a fraction of the production of the field as a whole, rather than on the production of their individual tracts. See *id.* at B5, E3-E7. Petitioners, whose interest was determined to be 17.33183% of the entire field, voted against unitization (see *id.* at E7). The Supervisor of Wells found, however, that the unitization plan had been approved by the owners entitled to receive at least 75% of the royalties, as required by Mich. Comp. Laws Ann. § 319.357 (West 1984), and the plan went into effect (*id.* at B7, E7, F1-F3).[3]

Petitioners received royalty payments in 1975, 1976, and 1977 on the oil produced from the Columbus 3 Pool, according to the allocation provided in the unitization plan. Petitioners originally reported the payments received by them in 1975 and 1976 as ordinary income on their federal

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[3] Petitioners challenged the unitization order by means of an administrative appeal and, when that was denied, through a lawsuit in state court. Their basic challenge to implementation of the plan was rejected, but the Michigan Court of Appeals did remand the case to the circuit court to provide petitioners an opportunity to show that their royalty interest under the unitization plan should be increased. See Pet. App. B6-B7; *Wronski* v. *Sun Oil Co.*, 108 Mich. App. 178, 310 N.W.2d 321 (1981).

income tax returns. They treated the payments received by them in 1977 as capital gains, however, on the theory that the payments constituted proceeds of an "involuntary conversion" of their property as a result of "an exercise of the power of requisition or condemnation," within the meaning of Section 1231 of the Code. Thereafter, petitioners filed amended returns for 1975 and 1976 claiming capital gain treatment for the payments received in those years under the same theory. Pet. App. B7-B8.

On audit, the Commissioner concluded that the royalty payments received by petitioners were taxable as ordinary income, and accordingly determined a deficiency. Petitioners then sought review in the Tax Court, which upheld the Commissioner's determination that the royalty payments were taxable as ordinary income (Pet. App. B1-B14). The court stated that the term "requisition or condemnation" in Section 1231 refers to an exercise of the power of eminent domain (*id.* at B11), and that the purpose of the Michigan unitization statute is to regulate the extraction of oil and gas so that the interests of all parties "will be protected—not taken away" (*id.* at B12). The court concluded that "[t]he Michigan unitization procedure represents a regulation of the extraction process to avoid [one landowner's operating to the detriment of others], not the exercise of the power of eminent domain, nor does it constitute an involuntary conversion of property interests of the affected parties" (*id.* at B12-B13). Accordingly, the Tax Court held that there was no involuntary conversion of petitioners' property under Section 1231 and therefore no basis for capital gain treatment of the royalty payments (*id.* at B13-B14). The court of appeals affirmed "upon the opinion of the Tax Court" (*id.* at A1).

2. The decision below is correct and does not conflict with any decision of this Court or of another court of ap-

peals. There is accordingly no reason for review by this Court.

It is undisputed that royalty payments are taxable as ordinary income, subject to a depletion allowance, rather than as capital gain. See *Burnet* v. *Harmel*, 287 U.S. 103 (1932). Petitioners rely on Section 1231 of the Code, which permits proceeds of an "involuntary conversion" of property used in a trade or business or of capital assets to be treated as capital gains, but the courts below correctly held that Section 1231 has no application here. The purpose of the unitization order was to regulate the extraction of oil and gas from the Columbus 3 Pool and to determine the allocation of the proceeds, not to take the property of any owner for public use. Petitioners retained title to their land and to the oil and gas under their land, and they continued to receive royalties on their share of the production of the field. See Pet. App. B12. From petitioners' perspective, the only change was in the manner in which the royalties were calculated, specifically, the fact that unitization yielded computation of the royalties based on the production of the field as a whole, with an allocation to each tract, instead of determining the amount directly produced by each tract.[4]

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[4] The unitization plan allocated the production among the various tracts in accordance with a formula that reflected the amounts of oil and gas contained in each tract and the amount of oil produced from each tract during the fourth quarter of 1971. Pet. App. E7-E8. The production allocated to each tract was then distributed among the parties having an interest in that particular tract "in the same manner, in the same proportions, and upon the same conditons" as if the unitization agreement had not been entered into (*id.* at G9). In other words, once the portion of the total production was allocated to petitioners' tracts, they received the royalty percentage that they had negotiated in their leases (see *id.* at E15).

Petitioners argue that the unitization plan, while not a direct condemnation by the state, was a form of "inverse condemnation" (Pet. 19-20). The premise of petitioners' argument appears to be that the royalties that they receive under the unitization plan are too small because one of the largest parts of the field is located under their tracts. Whatever the merit of that argument—and it was presented to the Michigan courts (see Pet. 12 & n.8)—it has no bearing on the tax treatment of the royalty payments at issue here. Plainly, the claim that petitioners should have received *more* royalties provides no basis for disputing the ordinary income character of the royalty payments that they did receive, which were based on the allocation between petitioners' royalty interests and the working interests that had been agreed to in the leases (see note 4, *supra*). Those royalty payments were ordinary income when received by petitioners under the leases, and they remained ordinary income when received pursuant to the unitization plan. Cf. *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130 (1960) (payments for fair rental value of business seized and operated by government during the war was ordinary income, not gain from "involuntary conversion").[5]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

JULY 1988

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[5] Petitioners' reliance (Pet. 30) on Rev. Rul. 68-226, 1968-1 C.B. 362, is misplaced. That ruling involved the sale by a lessee of his entire leasehold interest (or an undivided portion thereof) in oil and gas in place, not royalty payments based on the extraction of a specific amount of the minerals in place.

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